



MIT Center for  
Energy and Environmental  
Policy Research

**The Geoeconomics of  
Russian-EU Gas Trade:  
Drawing Lessons from the South  
Stream Pipeline Project**

Antto Vihma and Umut Turksen

November 2015

CEEPR WP 2015-014

# The Geoeconomics of Russian-EU Gas Trade: Drawing Lessons from the South Stream Pipeline Project

Dr. Antto Vihma

Senior Research Fellow, Finnish Institute of International Affairs, Helsinki, Finland, e-mail: [antto.vihma@fiia.fi](mailto:antto.vihma@fiia.fi) and  
Center for Energy and Environmental Policy Research (CEEPR), MIT, Cambridge, MA 02139

Dr. Umut Turksen

Professor of Law, Kingston University, London, UK, e-mail: [U.Turksen@kingston.ac.uk](mailto:U.Turksen@kingston.ac.uk) and  
Commonwealth Legal Education Association, London, UK

Energy trade has developed into one of the most contentious and divisive issues between Russia and EU in the post-Cold War era. It reflects a broader geoeconomic struggle in which economic means are used to advocate geopolitical goals. This Working Paper argues that the case of the South Stream Pipeline Project (SSPP) – a grand project abruptly cancelled by President Putin in December 2014 – epitomizes these broader power politics involved in the energy relations between the two powers. In 2014 the Russian leadership advanced both traditional geopolitical and contemporary geoeconomic strategies, pursuing the former by conducting a military campaign in Crimea and Eastern Ukraine, and utilizing the latter by pushing the construction of South Stream in spite of the EU's legal and political objections. The EU was able to harden its line on SSPP. The global energy context, including cheap coal prices, expansion of renewable energies, more liquefied natural gas and spot trading, cannot fully account for the assertiveness of the EU Commission and the allegiance of Member States in the SSPP case. The results of the process tracing conducted in this Working Paper confirm that in the case of the SSPP, Russian traditional geopolitics greatly hindered its geoeconomic power towards the EU. Furthermore, the Working Paper suggests that the strategic choices of geoeconomics vs. geopolitics may be more generally incompatible, even mutually exclusive. Russian geoeconomic activity has long been successful as a *centrifugal*, dividing power within the EU. The geopolitical campaign in Ukraine, in stark contrast, has been a *centripetal* force, causing increasing EU unity, eventually also seen in the SSPP case. It seems that claims of geoeconomics being a continuation of war by other means are potentially misleading. The means of geopolitical power projection and tools of geoeconomic power have notably different effects in the contemporary, interconnected world.

---

## 1. Introduction

In the post-Cold War era, energy security and trade between the European Union (EU) and the Russian Federation (Russia) were projected to become the glue that binds the two powers together in peaceful and prosperous trade relations based on mutual benefit and interdependence<sup>1</sup> – despite the growing asymmetry between liberal approaches to the energy sector in the EU and the illiberal state-centric environment in Russia.<sup>2</sup> In the current state of affairs, however, energy trade reflects a broader *geoeconomic* struggle in

---

<sup>1</sup> See Haukkala, H. 2014. "Towards a Pan-European energy order? Energy as an object of contention in EU-Russia relations", *Oil, Gas & Energy Law Intelligence* Vol.12 No.4, pp. 1-26 and Dizdarevic, N. 2014. "Regulatory Aspects Behind a Realization of the South Stream", *Oil, Gas & Energy Law Intelligence* Vol.12, Issue 2.

<sup>2</sup> Aalto, P. (ed.), *The EU-Russian Energy Dialogue: Europe's Future Energy Security* (Ashgate Publishing, 2008) and Van Der Meulen E. F., 2009. "Gas Supply and EU-Russia Relations," *Europe-Asia Studies*, Vol. 61, No. 5, pp. 833-856.

which economic means are used to advocate geopolitical goals. The concept of geoeconomics rivals both economic liberalism and traditional geopolitics as the paradigm of foreign and economic policies of states, and the evaluation of their national interests.<sup>3</sup> Geoeconomics challenges the liberal interdependency paradigm by underscoring the strategic interests – zero-sum interests that do not function in the logic of commerce – in economic relations between states.<sup>4</sup> At the same time, departing from traditional geopolitics, which connotes conventional military power projection,<sup>5</sup> geoeconomics highlights softer, economic versions of balancing behavior.

This paper argues that the case of the South Stream Pipeline Project (SSPP) epitomizes the geoeconomic power politics involved in the energy relations between the EU and Russia. For Russia, the SSPP has been an instrument of a geoeconomic strategy to advance specific goals: to secure Russian influence in Ukraine; to maintain Gazprom's dominant market share in the EU; to maintain the Russian sphere of influence on the EU Member States which rely on Russian energy; and to undermine European unity in energy and foreign policy.<sup>6</sup> For the EU, by contrast, opposition against the SSPP stems from the long-term policy goal of limiting the Russian geoeconomic influence within the EU, framed as concern over energy security and the functioning of the single EU energy market.

The process tracing presented in this article examines the demise of SSPP especially against the hypothesis that the EU-level opposition to the project and Member State adherence was strengthened as a result of Russian military aggression in Ukraine. The process tracing draws on public sources,<sup>7</sup> and establishes the key trajectories of change and causal sequence both on the EU and the Russian side. Careful description is the foundation of process tracing, and a crucial building block for analysis.<sup>8</sup> The results confirm the hypothesis that, in the case of the SSPP, Russian geopolitics greatly hindered its geoeconomic power vis-à-vis the EU. Furthermore, the analysis suggests that the big strategic choices of geoeconomics vs. geopolitics may be generally more incompatible, perhaps even mutually exclusive.

The paper is structured as follows. First, it discusses geoeconomics as a framework for foreign policy analysis, outlining the main drivers of the current interest in geoeconomics. The paper then turns to the context of geoeconomics in natural gas trade between Russia and the EU. It outlines the principles behind the EU-level gas policy, the conflicting interests of Member States, and the geoeconomic *divide et impera* strategy of Russia towards the EU. Subsequently, the paper presents a detailed case study of the SSPP, which

---

<sup>3</sup> For the evolution and a comparison of geoeconomic schools of thought in Russia and the Western Europe and the United States, see Anokhin A. and Lachininskii S., 2015. Evolution of the Ideas and Contents of Geoeconomic Studies, *Regional Research of Russia*, Vol. 5, No. 1, pp. 90-95.

<sup>4</sup> Luttwak, E. 1990. "From Geopolitics to Geoeconomics: Logic of Conflict, Grammar of Commerce", *The National Interest* Vol. 20, pp. 125-130.

<sup>5</sup> Flint, C. Introduction to Geopolitics (London: Routledge, 2006), p. 28.

<sup>6</sup> Liuhto, K. 2010. *Energy in Russia's Foreign Policy*, Electronic Publications of Pan-European Institute 10/2010, p. 36. available at: [http://www.utu.fi/fi/yksikot/tse/yksikot/PEI/raportit-ja-tietopakettit/Documents/Liuhto\\_final\\_netti.pdf](http://www.utu.fi/fi/yksikot/tse/yksikot/PEI/raportit-ja-tietopakettit/Documents/Liuhto_final_netti.pdf).

<sup>7</sup> The most useful sources for SSPP news at the time the study was conducted were *Financial Times*, *The New York Times* and *Euractiv*.

<sup>8</sup> Collier, D. 2011. "Understanding Process Tracing", *Political Science and Politics* 44 (4), pp. 823-830; Mahoney, J. 2010. "After KKV: The New Methodology of Qualitative Research", *World Politics* Vol 62, No.1, pp. 120-147.

has been seen by analysts as epitomizing the Russian centrifugal geoeconomic power in the EU's energy policies,<sup>9</sup> focusing on the political struggle of 2014. Lastly, some conclusions are drawn.

## 2. The Rise of Geoeconomics

There is an emerging body of literature that sees geoeconomics as a rising – or to be more accurate, returning – framework of foreign policy analysis.<sup>10</sup> The concept of geoeconomics was originally coined for this type of policy analysis by strategist and political scientist Edward Luttwak in a seminal essay in 1990.<sup>11</sup> Luttwak pointedly criticized the optimism surrounding the end of the Cold War, new global interdependence, and its beneficial consequences, in which “the logic of conflict itself, which is adversarial, zero-sum, and paradoxical”, would be displaced.<sup>12</sup> Instead, he envisioned “a much less complete transformation of state action” by the emergence of geoeconomics.<sup>13</sup> The concept of geoeconomics, invented and put forward by a non-economist, kick-started a debate between IR scholars and economists.<sup>14</sup> In his review of Luttwak's book, economist Raymond Vernon implied that the underlying idea of geoeconomics was to find status and jobs for the “ranks of underemployed geopoliticians” after the Cold War.<sup>15</sup> Realist IR scholars, in particular, countered that *laissez-faire* economists are “out in left field [...] because they are blind to the fact that economic activity is a source of power as well as well-being”.<sup>16</sup>

Geoeconomics gained some popularity in Washington in the 1990s, especially during the early years of the Clinton administration. According to Thirlwell, this was typically related to the anxiety caused by the economic competition from Japan.<sup>17</sup> However, economic liberalism gained much more traction in the form of globalization, taken here in the narrow sense of the word, consisting of international economic integration of markets for goods, services, capital and labor. The cooperative framework of multilateralism also took several important steps forward, notably in the fields of regional (NAFTA, ASEAN, EU) and international trade (World Trade Organization) and environment (Rio Conventions; Kyoto Protocol). Particularly in Europe, the growing interdependence – together with advances in multilateralism and the growing corpus of

---

<sup>9</sup> See for example, Jakóbi, W. 2014. “South Stream epitomises Russia's divisive energy politics in Europe”, available at: <http://blogs.lse.ac.uk/lsee/2014/08/08/south-stream-epitomises-russias-divisive-energy-politics-in-europe/>.

<sup>10</sup> Thirlwell, M. *The Return of Geoeconomics: Globalisation and National Security* (Sydney: The Lowy Institute for International Policy, 2010); Kundnani, H. 2011. “Germany as a Geoeconomic Power”, *The Washington Quarterly* Vol. 34, No.3, pp. 31-45; Martiningui, A. and Youngs, R. (eds). *Challenges for European Foreign Policy in 2012: What kind of geo-economic Europe?* (Madrid: FRIDE, 2011); Baru, S. *Understanding Geo-economics and Strategy* (Washington: International Institute for Security Studies, 2013); Szabo, S. *Germany, Russia, and the Rise of Geoeconomics* (London: Bloomsbury, 2014).

<sup>11</sup> Luttwak, *supra* note 4.

<sup>12</sup> *Ibid.*, p. 125.

<sup>13</sup> *Ibid.*, p. 126.

<sup>14</sup> For a good overview, see Thirlwell, *supra* note 10.

<sup>15</sup> Vernon, R. 1993. “Unclear and Present Danger: Review of ‘The endangered American dream’.” *The National Interest* 34, available at: <http://nationalinterest.org/bookreview/unclear-and-present-danger-446>.

<sup>16</sup> Huntington, S. 1993. “Why International Primacy Matters”, *International Security* Vol. 17, No 4, p. 72.

<sup>17</sup> *Ibid.* pp. 68-83.

international law – was seen to create a peaceful international environment in the spirit of *Pax Mercatoria*.<sup>18</sup> The founding assumption of the post-Cold War order in Europe was that economic integration would drive closer political cohesion within the EU as well as in its neighborhood.<sup>19</sup> It is hard to find an EU foreign policy strategy paper that does not include this notion.<sup>20</sup> The deepening of interdependency and solidarity was also seen as promoting the “European model”, delegating political authority to the supranational sphere and redefining power as surveillance in different networks, and thus underpinning the idea that “Europe will not run the world as an empire, but the European way of doing things will have become the world’s way”.<sup>21</sup>

As a result of harmonization and globalization of international trade in general, for Russia, similar to China, the export revenues have increased,<sup>22</sup> and Russia has become a major host for foreign direct investment (FDI), following initiatives for better integration in international trade. The Global Investment Trend Monitor published by UNCTAD indicates that, for the first time in history, Russia has become the third largest recipient of FDI. However, as addressed later in this article, the new geopolitical tensions between Russia, Ukraine and the Western countries have reversed this positive trend and, as a consequence, FDI fell to a record low in 2014 and 2015.<sup>23</sup>

After the “unipolar moment” and the advances in economic liberalism of the 1990s,<sup>24</sup> there has been a notable and increasing tendency for regional powers to consider the issues of trade and commerce through the prisms of national security and foreign policy. Scholars seem to concur, even if they do not use the term “geoeconomics”, and analyse world politics under the general banners of “zero-sum world”,<sup>25</sup> “multipolarity”,<sup>26</sup> or “multipolar order”.<sup>27</sup> Although Bernek has recently opined that “the grand strategies of the 21<sup>st</sup> century geopolitics will be pursued chiefly through economic means”,<sup>28</sup> the rise of geoeconomics by no means suggests that economic liberalism, rules-based multilateralism with legal treaties, or the geopolitics

---

<sup>18</sup> The idea of commerce reducing the likelihood of war dates back to the High Enlightenment and especially the writings of Immanuel Kant, who famously noted that “the spirit of commerce, which is incompatible with war, sooner or later gains the upper hand in every state”. See Kant, I. 1795 *Perpetual Peace* (New York: Cosimo, 2005), p. 39.

<sup>19</sup> “‘Fragmentation’ and ‘identity’ are reshaping the world”, *Financial Times*, 18 December 2014.

<sup>20</sup> For an illustrative example of interdependence idealism, see a keynote speech of former Finnish Foreign Minister Dr Erkki Tuomioja in the Finnish Parliament in February 2004: “*The European Union and Russia are tied together into a knot of positive interdependence. In many public statements our relation is often thus characterised as a ‘strategic partnership based on common values’. This touches upon something essential: our interaction and increased cooperation cannot but benefit us both.*” See “Foreign Minister Erkki Tuomioja: The EU and Russia - upcoming challenges of globalisation”, available at:

<http://formin.finland.fi/public/default.aspx?contentid=61044&contentlan=2&culture=en-US>.

<sup>21</sup> Leonard, M. *Why Europe Will Run the 21st Century* (New York: Public Affairs, 2005), p. 245.

<sup>22</sup> In 2014 Russia witnessed a 250-percent increase in capital outflow as compared to 2013. Kuchma A., “Russia is facing record capital and investment outflow”, *Russia Beyond the Headlines*, January 29, 2015.

[http://rbth.co.uk/business/2015/01/29/russia\\_is\\_facing\\_record\\_capital\\_and\\_investment\\_outflow\\_43261.html](http://rbth.co.uk/business/2015/01/29/russia_is_facing_record_capital_and_investment_outflow_43261.html).

<sup>23</sup> <https://en.santandertrade.com/establish-overseas/russia/foreign-investment>.

<sup>24</sup> Layne, C. 1993. “The Unipolar Illusion: Why New Great Powers Will Rise”, *International Security* 17 (4), pp. 5-51.

<sup>25</sup> Rachman, G. *Zero-sum World: Politics, Power and Prosperity After the Crash* (London: Atlantic Books, 2010).

<sup>26</sup> Kupchan, C. 1998. “After Pax Americana: benign power, regional integration, and the sources of a stable multipolarity”, *International Security* 23 (2), pp. 40-79

<sup>27</sup> Turner, S. 2009. “Russia, China and a multipolar world order: The danger in the undefined”, *Asian Perspective* Vol. 33, No. 1, pp. 159-184

<sup>28</sup> Bernek A., 2015. “The “Grand Chessboard” of the 21<sup>st</sup> Century Geopolitical Strategies of the Multi-polar World”, *National Security Review*, Special Issue / MMXV.

of conventional military power are things of the past. Nor does it claim that geoeconomic conduct is a new phenomenon, as there has always been a significant degree of overlap and convergence between these various strands of policy areas such as international economics, foreign relations, and security.<sup>29</sup> However, equally important is the fact that over time significant shifts have occurred both in the relative importance of these linkages, and in the attention paid to them.<sup>30</sup> The argument simply suggests that geoeconomic conduct is gaining in relative importance, and as a result, scholars and analysts are beginning to pay more attention to it.

There are many interrelated reasons for this relative change in world politics and, taken together, these factors underpin the current relevance of geoeconomics. The first major factor is the rise of China and the subsequent shifts in global economic power.<sup>31</sup> Much of the contemporary academic and policy discussion in world politics is about the strategic implications of a multipolar world or, more narrowly, about the consequences of the economic rise of China. The possible agreement following the transformation has been termed by some analysts as the “global grand bargain”.<sup>32</sup> The second related issue is the rise of the state capitalist model for development. The versions of bureaucratically engineered capitalism<sup>33</sup> are particular to each government that practices them, with primary working tools including national oil and gas corporations, other state-owned enterprises, privately owned national champions, sovereign wealth funds, and state-owned banks.<sup>34</sup> Thirdly, the financial crisis and the humiliation of the deregulated market system from 2008 onwards have weakened the liberal argument and highlighted the link between the economy and security. The financial crisis has had broad consequences, for example in Europe, where a commonly heard view has long been that the EU was “punching below its weight”<sup>35</sup> in international affairs due to its preoccupation with internal developments. This condition has become more severe in the context of the eurozone crisis. Fourthly, the growing focus in international relations on resource scarcity<sup>36</sup> highlights security of supply and zero-sum thinking. The rapid growth, industrialization and urbanization of Asia’s populous economies have temporarily caused high resource prices and the return of neo-Malthusian anxieties.

The current importance of geoeconomics highlights its differences from and similarities to the traditional geopolitical perspective. For instance, the geopolitical direction based on “hard power”, in other words, military power and spending, to a great extent depends on economic strength. At the same time, countries are reluctant to utilize military force and instead rely on their economic influence for their foreign policies and strategies. While this may be achieved on the back of trading valuable commodities or resources

---

<sup>29</sup> See for example, Mattlin, M. and Wigell, M. 2015. “Geoeconomics in the Context of Restive Regional Powers”, *Asia Europe Journal* (forthcoming).

<sup>30</sup> Thirwell, *supra* note 10.

<sup>31</sup> Fenby, J. *Will China Dominate the 21st Century?* (Cambridge: Polity, 2014) and Mearsheimer, J. 2014. “Can China Rise Peacefully?”, *The National Interest*, 8 April 2014.

<sup>32</sup> Hutchings, R. and Kempe, F. 2008. “The Global Grand Bargain”, *Foreign Policy*, 5 November 2008.

<sup>33</sup> Also referred to as non-market economies and / or socialist capitalist economies.

<sup>34</sup> Bremmer, I. *The End of the Free Market: Who Wins the War between States and Corporations?* (New York: Portfolio, 2010).

<sup>35</sup> Thomas, D. 2012. “Still Punching below Its Weight? Coherence and Effectiveness in European Union Foreign Policy”, *Journal of Common Market Studies* Vol. 50, No. 3, pp. 457-474.

<sup>36</sup> Lee, B. 2013. The Geopolitics of the Modern Resource Boom. *Americas Quarterly* Vol. 7, No. 1, pp. 44-50.

(i.e. oil and gas), it can also be achieved by direct participation in the state's financial system via trade in services and investment – for example, Russia's largest commercial bank, Sberbank, has become a major player not only in EU Member State economies such as Austria and Hungary, but also in the EU more generally since 2012.<sup>37</sup> Accordingly, geoeconomic strategies and realities include employment of various trade mechanisms and in turn underpin the realisation of political influence and foreign policy objectives.

### 3. Geoeconomics in the EU-Russia Natural Gas Trade

Under Vladimir Putin's reign, a "fundamental reference point for Russia's economic ideology is national security".<sup>38</sup> In this view, liberal ideologies are seen as enemies of Russia's "nationally minded economy" – the success of which should be measured against the ability to ensure Russia's national interests, not against the "false benchmarks of economic liberalism".<sup>39</sup> For Russia, this geoeconomic *modus operandi* almost inevitably involves natural gas.<sup>40</sup> Russia is among the world's biggest energy exporters, but without the sale of its energy products, the value of Russian exports is smaller than that of Poland's.<sup>41</sup>

Luttwak has already noted that the propensity of states to act geoeconomically will vary greatly, even more than their propensity to act geopolitically.<sup>42</sup> Geoeconomic activity is contextual, and limited and enabled by two broad factors: political ideology and state-private sector interactions.<sup>43</sup> Firstly, in the field of political ideology, some states resist acting geoeconomically for institutional, doctrinal and political reasons, especially if they are deeply committed to moral politics or a *laissez-faire* attitude.<sup>44</sup> A political struggle takes place in the domestic sphere of different countries in varied political contexts, in which some constituencies demand geoeconomic activism from the state, and some argue against it. On the other hand, as discussed later in this article, traditional geopolitical conduct such as a conventional military power projection will also limit the possibilities of geoeconomic strategies.

Secondly, an equally important variable is the nature of the coexistence of state and private economic operators. Their coexistence can be passive, for example in the case of a large group of small, localized service businesses. In the energy sector, the relationship is typically different, as manifested by the

---

<sup>37</sup> Sberbank has acquired ownership of the Austrian Volksbank International, which is an important bank in a number of EU Member States. In addition, Sberbank and Cetelem, the consumer lending division of the BNP Paribas Group, and the leading provider of consumer loans in France and Europe, have signed on 26 December 2011 a binding partnership agreement to create a joint venture for a Russian POS in which the 70% majority stake is held by Sberbank. <http://www.bnpparibas.com/en/news/press-release/sberbank-leading-russian-bank-and-cetelem-europes-leading-consumer-credit-player->; see also <http://www.ft.com/cms/s/0/20e926f2-b19c-11e2-9315-00144feabdc0.html#axzz3mU55L0D0>.

<sup>38</sup> Yakunin, V. I., Bagdasaryan, V. E. and Sulakshin, S. S. *Economic Policy Ideology* (Moscow: Governance and Problem Analysis Centre, 2009), pp. 226–231

<sup>39</sup> *Ibid.*

<sup>40</sup> If gas production remains at the current levels, Russia's current (discovered) gas reserves have been predicted to last more than 50 years. Paltsev S., 2014. "Scenarios for Russia's natural gas exports to 2050", *Energy Economics*, Vol. 42, pp. 262-170.

<sup>41</sup> For comparisons and illustrations, see The Atlas of Economic Complexity by the Massachusetts Institute of Technology, available at: <https://atlas.media.mit.edu/en/profile/country/rus/>.

<sup>42</sup> Luttwak, *supra* note 4, p. 128.

<sup>43</sup> Luttwak, *supra* note 4, pp. 128-130.

<sup>44</sup> Szabo, *supra* note 10.



case of Russia and its energy giant, Gazprom. In the words of Luttwak, there is an intense positive interaction “between politically weighty businesses in need of state support on the world economic scene”, or conversely, the state “seeking to guide large companies for their own geoeconomic purposes, or even select[ing] them as their chosen instrument”.<sup>45</sup> In the Russian context, Yakunin *et al.* draw examples of success from the close inter-linkages between the state and business in the military, nuclear, oil and gas industries.<sup>46</sup> Gazprom holds a legal monopoly in natural gas exports and is directly under the control of the Kremlin. Russia’s energy strategy has been analyzed in terms of a “symbiotic relationship” between the state and leading companies.<sup>47</sup> As noted by Luttwak, in the geoeconomic game “the state can be both user and used, and companies both instruments and instrumentalizers”.<sup>48</sup> However, in spite of the rather clear control relationship, it is worth pointing out that Gazprom (as a company) and the Kremlin (as Putin’s power vertical) may also have diverging interests. Russian interest is not a monolith, and while Gazprom benefits from its privileged position, it is also restricted by political gas pricing both domestically and internationally, as well as geoeconomically-motivated hardline policies, such as the Ukrainian Gas Crisis in 2009. According to analysts, the critical and, for Gazprom, extremely costly decision to turn off the gas was likely made by then-Prime Minister Putin.<sup>49</sup> In February 2010, as Russia was again able to count on a sympathetic government in Kiev, the price of gas was cut by almost 30 per cent, and Russia gained a new 30-year contract for Sevastopol.<sup>50</sup> The price cut was so large that the Russian government financed it to Gazprom directly.<sup>51</sup> The 2009 gas crisis, as well as the current military operations in Ukraine, indicate rather clearly that Gazprom’s commercial interest is overrun by Kremlin power politics.

### 3.1 Russia’s natural gas policy turns to geoeconomics

There is little question that, in the 1990s, the EU and Russia were closely aligned with regard to the main features of the European energy order. The early years after the Cold War saw the birth of the European

---

<sup>45</sup> Luttwak, *supra* note 4, p. 129.

<sup>46</sup> Yakunin *et al.*, *supra* note 38.

<sup>47</sup> Bilgin, M. 2011. “Energy Security and Russia’s Gas Strategy: The symbiotic relationship between the state and firms”, *Communist and Post-Communist Studies* Vol. 44, No. 2, pp. 119-127. Gazprom has also been described as a company serving two masters: it issues shares to outside investors, therefore it should, at least in theory, aim to maximise profits in the long run. However, because it is majority-owned by the Russian state, it pursues political and foreign policy goals. Economically, the company is run inefficiently: The Peterson Institute for International Economics reported that although Gazprom posted nominal profits of \$46 billion in 2011, it lost \$40 billion to “corruption and inefficiency”. See *The Economist*, Russia’s wounded giant, 23 March 2013, <http://www.economist.com/news/business/21573975-worlds-biggest-gas-producer-ailing-it-should-be-broken-up-russias-wounded-giant>.

<sup>48</sup> Luttwak, *supra* note 4.

<sup>49</sup> Pirani, S., Stern J and Yafimava, K. 2009. “The Russo-Ukrainian gas dispute of January 2009: a comprehensive assessment”, Oxford Institute for Energy Studies, available at: <http://www.oxfordenergy.org/wpcms/wp-content/uploads/2010/11/NG27-TheRussoUkrainianGasDisputeofJanuary2009AComprehensiveAssessment-JonathanSternSimonPiraniKatjaYafimava-2009.pdf>.

<sup>50</sup> Pirani, S., Stern J and Yafimava, K. 2010. “The April 2010 Russo-Ukrainian gas agreement and its implications for Europe”, Oxford Institute for Energy Studies, available at: [http://www.oxfordenergy.org/wpcms/wp-content/uploads/2011/05/NG\\_42.pdf](http://www.oxfordenergy.org/wpcms/wp-content/uploads/2011/05/NG_42.pdf).

<sup>51</sup> *Ibid.*



Energy Community in 1990,<sup>52</sup> the European Energy Charter in 1991,<sup>53</sup> the Energy Charter Treaty in 1994,<sup>54</sup> and the Partnership and Cooperation Agreement 1994.<sup>55</sup> The agenda was to achieve a system functioning under open market principles and the rule of law, based on Western norms and standards, across the wider European energy market, “encompassing production countries from the Atlantic to Vladivostok”.<sup>56</sup> The non-energy-related function of these governance arrangements was to contribute to overall European stability by spurring integration, contributing to the development of the single market as well as exporting legal norms to Eastern Europe.<sup>57</sup>

The initial optimistic agenda informed by the rule of law ran into obvious difficulties as Russia gradually hardened its stance. The emerging Russian position was a profoundly geoeconomic one, based on bilateral, state-centric and sovereignty-bound practices. Many scholars have analyzed Russia’s policies, in which it uses the control over energy streams to Europe as a means to enhance its foreign policy influence and regional power status.<sup>58</sup> The same stance can be also seen in key Russian policy documents, such as the Energy Strategy for 2020, which already in 2003 noted explicitly that energy resources constitute an instrument of the internal and external policies of Russia,<sup>59</sup> as well as the latest Energy Strategy of 2009, which states that “[t]he aim of Russia's energy policy is the most efficient use of natural energy resources and sustainable economic growth, improving the quality of life of the population and to promote foreign policy positions”.<sup>60</sup> This is a clear indication that Russia sees its energy resources and companies as instruments of political influence, not merely as economic operators.

In April 2004, the Energy Charter Treaty signed during the Yeltsin presidency was removed from the State Duma agenda for “flatly contradicting the national interests of Russia” and for “being imposed on

---

<sup>52</sup> See Energy Community webpages, available at: [https://www.energy-community.org/portal/page/portal/ENC\\_HOME/ENERGY\\_COMMUNITY](https://www.energy-community.org/portal/page/portal/ENC_HOME/ENERGY_COMMUNITY).

<sup>53</sup> For background, see European Energy Charter, available at: [http://europa.eu/legislation\\_summaries/energy/external\\_dimension\\_enlargement/l27028\\_en.htm](http://europa.eu/legislation_summaries/energy/external_dimension_enlargement/l27028_en.htm).

<sup>54</sup> *Ibid.*

<sup>55</sup> See Partnership and Cooperation Agreements (PCAs), available at: [http://europa.eu/legislation\\_summaries/external\\_relations/relations\\_with\\_third\\_countries/eastern\\_europe\\_and\\_central\\_asia/r17002\\_en.htm](http://europa.eu/legislation_summaries/external_relations/relations_with_third_countries/eastern_europe_and_central_asia/r17002_en.htm).

<sup>56</sup> Haukkala, *supra* note 1.

<sup>57</sup> Axelrod, R. S. 1996. “The European Energy Charter Treaty: Reality or Illusion?” *Energy Policy* Vol. 24, No. 6, pp. 497–505.

<sup>58</sup> Legvold, R. (ed.) *Russian Foreign Policy in the 21st Century & the Shadow of the Past* (New York: Columbia University Press, 2007); Goldman, M. I. *Petrostate: Putin, Power, and the New Russia* (Oxford and New York: Oxford University Press, 2008); Finon, D. and Locatelli, C. 2008. “Russian and European gas interdependence: Could contractual trade channel geopolitics?”, *Energy Policy* 36 (1), pp. 423–442; P. Aalto (ed.) *The EU–Russian Energy Dialogue: Europe’s Future Energy Security* (Aldershot: Ashgate, 2009); Perovic, J., Orttung, R. W. and Wenger, A. (eds) *Russian Energy Power and Foreign Relations: Implications for Conflict and Cooperation* (London and New York: Routledge, 2009); Nowak, B. 2010. “Forging the External Dimension of the Energy Policy of the European Union”, *The Electricity Journal* 23 (1), pp. 57–66; Liuhto, *supra* note 6; Haukkala, *supra* note 1; Dizdarevic, *supra* note 1.

<sup>59</sup> Ministry of Energy of the Russian Federation. 2003. *The Summary of the Energy Strategy of Russia for the Period of up to 2020*. Available at [http://www.energystrategy.ru/projects/docs/ES-2030\\_\(Eng\).pdf](http://www.energystrategy.ru/projects/docs/ES-2030_(Eng).pdf).

<sup>60</sup> Direct quotation is as follows: “Целью энергетической политики России является максимально эффективное использование природных энергетических ресурсов и потенциала энергетического сектора для устойчивого роста экономики, повышения качества жизни населения страны и содействия укреплению ее внешнеэкономических позиций”, available at: [http://minenergo.gov.ru/activity/energostrategy/ch\\_1.php](http://minenergo.gov.ru/activity/energostrategy/ch_1.php).

Russia from the outside”.<sup>61</sup> It is crucial to note that the negotiations over energy trade in the 2000s were not only of a legal and technical nature, with rational positions stemming from security of supply versus security of demand, and different expectations concerning proper prices and contracting. The negotiations had undertones of great-power politics, including the politicized “energy weapon” threatening the EU and, on the other side, the EU scheming and employing political double standards to “punish” the growing Russian economy and power. In 2009 Russia formally withdrew from the Energy Charter Treaty,<sup>62</sup> stating that the key reason was third-party access enabled by the regime, which would allow former Soviet countries to access infrastructure dominated by Russian companies. It is not legally certain whether the Energy Charter Treaty would actually do this, but Russia decided to frame the issue of leaving the Treaty in this manner.<sup>63</sup> A number of analysts observed that “eventually the discussion [around the ECT] moved to a virtual space, in which some non-existent provisions of the ECT were hotly debated [...]. This ‘virtual background’ created the informational background for Russia’s adoption of the decision to withdraw from the ECT.”<sup>64</sup> Furthermore, Russia enacted two federal statutes, which were aimed at restricting access for foreign investors and non-state-controlled Russian energy companies to the upstream oil and gas markets in Russia.<sup>65</sup>

Frustrated by the lack of success with the treaty-based approach, the EU has continued to pursue the dialogue on energy under the auspices of the bilateral Energy Dialogue since 2000,<sup>66</sup> and the EU-Russia Energy Roadmap since 2011.<sup>67</sup> In the meantime, the EU set off to create a fully integrated regulatory regime for its internal energy market via a number of legal instruments<sup>68</sup> whilst continuing its efforts to materialize a multilateral energy trade regime.<sup>69</sup> Russia’s withdrawal and call for an alternative framework seemingly acted as a catalyst for the modernization process of the Energy Charter and even served the initiative of the

---

<sup>61</sup> Haukkala, *supra* note 1, p. 9.

<sup>62</sup> Russian Prime Minister Vladimir Putin issued a decree on 30 July 2009 declaring Russia’s rejection of the Energy Charter Treaty. Daria Nochevnik, Russia and the Energy Charter Process: Which Way Forward?, *European Energy Review*, 03 August 2015: <http://www.europeanenergyreview.eu/russia-and-the-energy-charter-process-which-way-forward>.

<sup>63</sup> Talus, K. 2013. “Kansainväliset maakaasumarkkinat ja niiden sopimukset: Kehitys, sääntely ja riskit”, *Defensor Legis* 6/2013.

<sup>64</sup> Nochevnik, *supra* note, citing Konoplyanik 2011 Energeticheskaja hartija: otmenit’ nelzya modernizirovat [suggested translation of the article’s title: ‘Energy Charter: to abolish impossible to modernise’], *Russian National Economic Journal*, No 2 (440): 118-136.

<sup>65</sup> The Federal Law (No57-FZ) *On Foreign Investments in Business Entities of Strategic Importance for National Defense and State Security* and the Federal Law (No58-FZ) *On Amendments to Certain Legislative Acts of the Russian Federation and the Annulment of Certain Provisions of Legislative Acts of the Russian Federation in connection with the adoption of the Federal Law On the Procedures for Foreign Investments in Companies of strategic importance for national defense and security of the state*.

<sup>66</sup> See “EU Russia-Energy Dialogue”, available at: <http://ec.europa.eu/energy/en/topics/international-cooperation/russia>.

<sup>67</sup> Similarly, see: “Roadmap: EU-Russia Energy Cooperation until 2050”, available at: [http://ec.europa.eu/energy/sites/ener/files/documents/2013\\_03\\_eu\\_russia\\_roadmap\\_2050\\_signed.pdf](http://ec.europa.eu/energy/sites/ener/files/documents/2013_03_eu_russia_roadmap_2050_signed.pdf).

<sup>68</sup> The EU internal energy market is regulated under the Third Energy Package which consists of two Directives and three Regulations: Directive 2009/72/EC concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC; Directive 2009/73/EC concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC; and Regulation (EC) No 714/2009 on conditions for access to the network for cross-border exchanges in electricity and repealing Regulation (EC) No 1228/2003; Regulation (EC) No 715/2009 on conditions for access to the natural gas transmission networks and repealing Regulation (EC) No 1775/2005; Regulation (EC) No 713/2009 of the European Parliament and of the Council of 13 July 2009 establishing an Agency for the Cooperation of Energy Regulators.

<sup>69</sup> *Op. cit.* International Energy Charter 2015.

EU to create a multilateral energy trading regime. Notably, when the first step of this modernization was completed, the ensuing political declaration, the International Energy Charter, was endorsed (with a number of new countries coming on board, including China).

Figure 1 provides a snapshot overview of Gazprom's natural gas pricing as a centrifugal force within the EU. The prices are negotiated on a country-by-country basis and attached to fluctuate with world oil prices according to a formula. The export prices and quantities were made public for the first time in 2013 pursuant to a new EU regulation.<sup>70</sup> By comparing, for example, the prices paid for 1000 cubic meters of gas by Hungary (\$391) and Poland (\$526), or Romania (\$431) and Bulgaria (\$501), it becomes clear that the differences cannot be explained by transportation distance or gas quantity. Instead, they are shaped by competition vs. degree of dependency, bilateral negotiations, and political discounts.

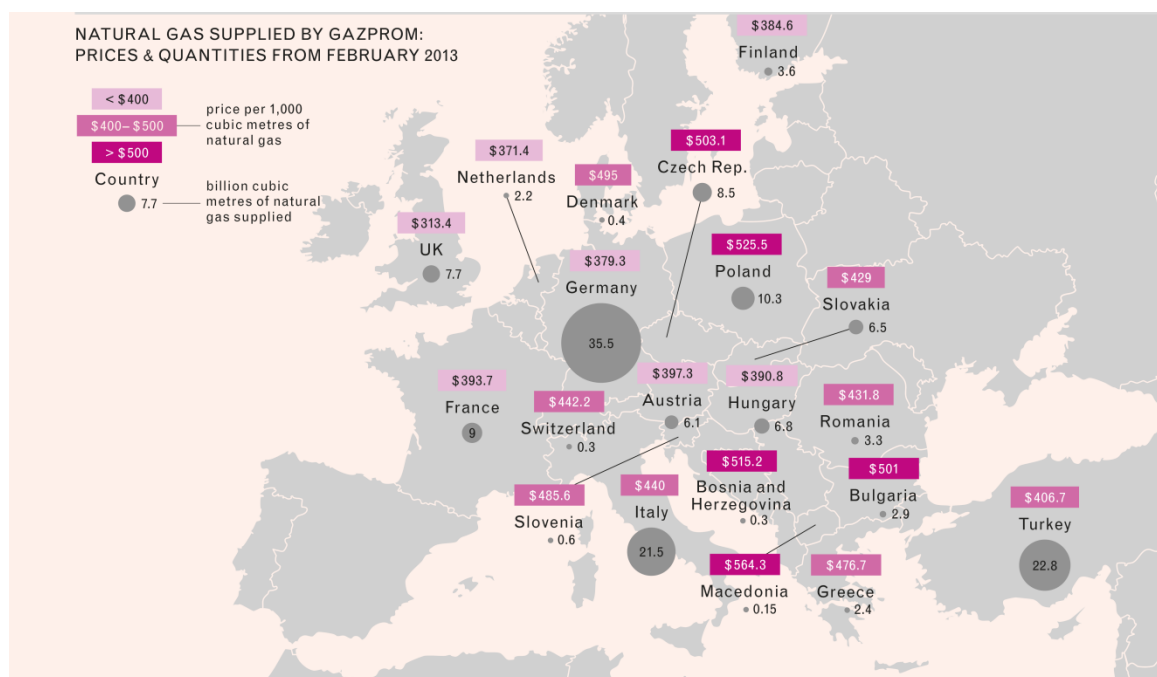


Figure 1. European natural gas prices and quantities imported from Russia in 2012.<sup>71</sup>

Russia has used gas exports as a carrot, on the one hand, giving discounts especially to sympathetic governments in the former Soviet countries and to “strategic partners” in Western Europe, and, on the other hand, as a stick, giving “hard” contracts to the most dependent states with unsympathetic governments. Indeed, the variation in gas prices (and contracts) between different customers in the EU cannot be explained on commercial grounds (Figure 1).<sup>72</sup> Here, the gas trade emerges as a “wedge strategy” in which gas discounts and renegotiated ‘secret’ agreements act as an incentive against the EU’s unity and solidarity. For

<sup>70</sup> Regulation (EU) No 994/2010 of the European Parliament and of the Council of 20 October 2010 concerning measures to safeguard security of gas supply and repealing Council Directive 2004/67/EC.

<sup>71</sup> The data for the illustration is drawn from the EU Commission via Dizdarevic, *supra* note 1.

<sup>72</sup> Stegen, S. K. 2011. “Deconstructing the ‘energy weapon’: Russia’s threat to Europe as case study”, *Energy Policy*, Vol. 39, No. 10, pp. 6505–6513.

instance, Gazprom has given favorable and flexible contracts to its German partners (\$379.3 per 1000 cubic meters, see Figure 1) such as E.ON and chemical giant BASF,<sup>73</sup> companies that also hold sizeable shares in Yuzhno-Russkoye gas fields.<sup>74</sup> Russia's incentive-oriented gas policies have encouraged German politicians not to pursue EU unity and collective action on the energy front.<sup>75</sup> While German ex-chancellor Schröder joined the board of Gazprom and backed the Russian action in Ukraine,<sup>76</sup> chancellor Merkel led the effort to block the proposed EU regulations to limit the ability of foreign companies to buy European energy utilities – a measure aimed at addressing Gazprom's monopolistic position in the EU gas markets.<sup>77</sup> Russia, in turn, sees its relationship with Germany as a valuable asset for asserting greater influence in European affairs.<sup>78</sup> Similar energy geoeconomics is focused on many other actors and states as well. For example, many important current and former national energy champions – in small and large EU Member States alike – have close ties with the Russian energy sector. The leading French electricity group, EDF, has joint ventures with Gazprom, while GDF (now Engie) and Total are closely linked to various Russian companies. Likewise, Italy's ENI is a founding partner of the controversial South Stream pipeline project (addressed below).

The EU political institutions, the Council,<sup>79</sup> the Parliament<sup>80</sup> and the Commission, have repeatedly taken a stand on a “common foreign energy policy strategy” that goes beyond the single market, underscoring the need for a strategic foreign policy approach in energy relations.<sup>81</sup> Several Member States have joined the position. Poland, for example, with an unfavorable gas contract (\$525.5 per 1000 cubic meters, see Figure 1) and several other disputes with Russia, has lobbied hard for “energy solidarity” and the Europeanisation of energy security since the 2006 Russia-Ukraine gas crisis.<sup>82</sup> However, while the EU institutions, the Commission in particular, have been keen to underscore a more unified policy in external

<sup>73</sup> Turksen, U. 2014. “Euro-vision of energy trade with Russia: Current problems and future prospects for EU solidarity in energy trade”, *Oil, Gas & Energy Law Intelligence* Vol. 12, Issue 4, pp. 1-40.

<sup>74</sup> See Gazprom, <http://www.gazprom.com/about/production/projects/deposits/ymr>.

<sup>75</sup> Judah B., *et al.*, 2011. “Dealing with a Post-Bric Russia, European Council on Foreign Relations”, p. 50 citing Rettman A., “Polish FM in Wikileaks: Germany is Russia's Trojan horse”, *EU Observer*, 16 September 2011. [www.ecfr.eu/page/-/ECFR44\\_RUSSIA\\_REPORT\\_AW.pdf](http://www.ecfr.eu/page/-/ECFR44_RUSSIA_REPORT_AW.pdf).

<sup>76</sup> See, RT News, Ex-Chancellor Schroeder criticizes Merkel's Russia policy, 28 March 2015, <http://www.rt.com/news/244909-germany-schroeder-russia-policy>; and Neukirch R, The Wrong Impression: Schröder's Russia Ties Are Bad Politics, 06 May 2014, <http://www.spiegel.de/international/germany/embrace-of-putin-by-schroeder-bad-for-german-foreign-policy-a-967900.html>.

<sup>77</sup> The extent of Germany's involvement in Russia's economy is beyond the scope of this paper. While it is worth mentioning that Germany has had a very successful and profitable track record of doing business in Russia, this has come with risks and a political price. See Szabo, *supra* note 10.

<sup>78</sup> Stelzenmuller C., “Germany's Russia Question – A new Ostpolitik for Europe”, (April/March 2009) *Foreign Affairs*, 89; Helm D. “Russia, Germany and the European Energy Policy”, 14 December 2006: [http://www.opendemocracy.net/globalizationinstitutions\\_government/energy\\_policy\\_4186.jsp](http://www.opendemocracy.net/globalizationinstitutions_government/energy_policy_4186.jsp).

<sup>79</sup> European Council Conclusions on the Energy Union, 29 March 2015, Press Release 139/15: <http://www.consilium.europa.eu/en/press/press-releases/2015/03/conclusions-energy-european-council-march-2015>.

<sup>80</sup> European Parliament resolution of 26 October 2012 on EU-Russia trade relations following Russia's accession to the WTO (2012/2695(RSP)) - 2014/C 72 E/10;

<sup>81</sup> See Commission Decision No 994/2012/EU of the European Parliament and of the Council of 25 October 2012 establishing an information exchange mechanism with regard to intergovernmental agreements between Member States and third countries in the field of energy.

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32012D0994:EN:NOT>.

<sup>82</sup> Roth M. 2011 “Poland as a policy entrepreneur in European external energy policy: towards greater energy solidarity vis-à-vis Russia?” *Geopolitics*, Vol.16, Issue 3, pp. 600-625.

energy relations,<sup>83</sup> this stance has long been countered by Russian energy geoeconomics and the Member States' bilateral energy agreements with Russia. Even the simplest transparency and coordination measures have been challenging for the EU's external energy policy to achieve. For example, the first time Gazprom's gas prices were available to public was in 2013 thanks to a new EU regulation,<sup>84</sup> as Gazprom had long insisted that gas pricing agreements should be kept confidential.<sup>85</sup>

Furthermore, the most extreme measure of energy-related geoeconomic power, cutting the energy supplies for political reasons, became characteristic of Russian conduct after a long period of reliable deliveries. In the late 2000s, Russia was entangled in disputes with several countries over energy, which led to political cut-offs. For example, Russia cut off gas to the Czech Republic when it supported the US missile defense plan in 2008.<sup>86</sup> The most severe disruptions were the 2006 gas dispute with Ukraine, the explosion of the Turkmenistan-Russia pipeline in 2009, the 2006 and 2010 oil disputes with Belarus, and the second Ukrainian gas crisis in 2008/2009, which led to the severing of most of the supplies to Central and South East Europe. A prime example of the difficulties some EU countries faced was the situation in Bulgaria's biggest fertilizer plant, which received a fax at 4.30 am on 6 January 2009 warning that their gas supply was going to be cut off immediately.<sup>87</sup> An instant shutdown could have destroyed vital capital, such as the plant's pipes.<sup>88</sup> At the time of the empirical case analyzed in this paper, the push for South Stream in 2014, the gas supplies to Ukraine were cut off again, this time as a consequence of the conventional warfare in Eastern Ukraine.<sup>89</sup>

## 2.2 EU struggles to create an internal market for gas

As Russia began to increase its assertiveness and turn to geoeconomic means in its natural gas policy, the EU focused on developing a competitive single market for gas, especially after the failure of the broader multilateral treaty approach that included partner countries became evident. This strategy is partly to control Russian geoeconomic influence, expressed in terms of concern over energy security in various EU documents. The EU approach to energy law has been informed by its competition law principles and based on non-discriminative third-party access, the unbundling of production and transport of energy, and regulatory oversight by a public authority.<sup>90</sup> In doing so, the EU has aimed to strengthen the negotiating position of Member States, ensuring security of supply, proper functioning of the internal market and

---

<sup>83</sup> EU Commission (2008). Communication from the Commission to the European Parliament, the Council, the Economic and Social Committee, and the Committee of the Regions: Second Strategic Energy Review - An EU Energy Security and Solidarity Action Plan [COM (2008) 0781] and European Commission. (2008b). Memo: EU Energy Security and Solidarity Action Plan: Second Strategic Energy Review [MEMO (08) 703].

<sup>84</sup> Dizdarevic, *supra* note 1.

<sup>85</sup> Turksen, *supra* note 73.

<sup>86</sup> "Russia exerts its power", *Financial Times*, 31 October 2008,

<sup>87</sup> "Can Europe wean itself off Russian gas?", *Financial Times*, 14 October 2014.

<sup>88</sup> *Ibid.*

<sup>89</sup> "Gazprom Cuts Russia's Natural Gas Supply to Ukraine", *The New York Times*, 16 June 2014.

<sup>90</sup> Talus, *supra* note 63, p. 1021.

creating legal certainty for investment.<sup>91</sup> Furthermore, the High Representative of the EU for Foreign Affairs and Security Policy (HR) was invited to take full account of the energy security dimension in her work.<sup>92</sup> The policy developments and state practices indicate that the EU wants to ‘create a negotiated framework based on the principle of “equal market conditions” while state controlled Russian companies are pursuing “equal benefits to their partners in any transaction”’.<sup>93</sup>

The European natural gas market used to be based on monopolies, either *de jure* or *de facto*, and constrained by state boundaries.<sup>94</sup> The regulatory framework was country-based and national champions were protected from outside competition. The price of gas used to depend – and still does to a considerable degree – on long-term, take-or-pay contracts that are indexed with competing fuel prices, typically oil products. The motivation for long-term, oil-indexed take-or-pay contracts is to address the high investment costs of gas transportation and the energy security concerns of the supplier, of which Gazprom is the most significant (Figure 2). The duration of long-term contracts is typically 20 to 25 years. In a take-or-pay contract the buyer has an obligation to pay specific volumes whether the buyer uses the gas or not.

---

<sup>91</sup> European Council, Conclusions on Energy, 04 February 2011, (EUCO 2/1/11 Rev 1, 8 March 2011).

<sup>92</sup> *Ibid.* HR is the chief co-ordinator and representative of the Common Foreign and Security Policy (CFSP) within the European Union.

<sup>93</sup> Oxenstierna, S. and Tynkkynen, V-P. *Russian Energy and Security up to 2030* (London, Routledge, 2014) p. 91.

<sup>94</sup> For a detailed analysis of the EU energy law and regulation see, Talus K. *EU Energy Law and Policy: A Critical Account* (Oxford: Oxford University Press, 2013).

# NATURAL GAS TRADE BETWEEN EU, UKRAINE AND RUSSIA

SHARE OF NATURAL GAS IN TOTAL ENERGY CONSUMPTION  
/ EXPORTS TO & IMPORTS FROM RUSSIA

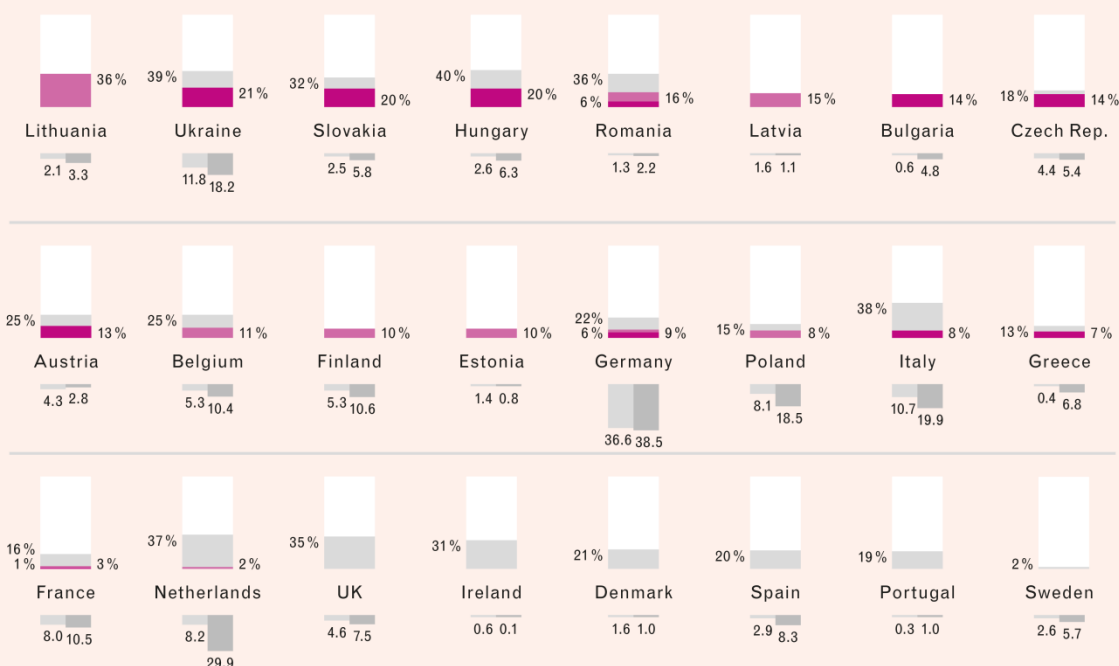
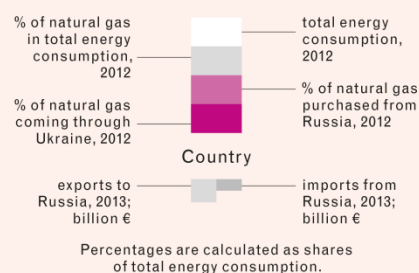


Figure 2. The share of natural gas, natural gas from Gazprom, and natural gas from Gazprom via Ukraine for EU Member States.<sup>95</sup>

Another important prerequisite of the market, namely the necessary connecting infrastructure, has been slow to materialize. The EU Commission has made regulatory efforts to overcome this state of affairs, through several directives that have been complemented by decrees and regulations. A notable regulatory milestone was the Third Energy Package proposed by the Commission in 2007 and which entered into force in 2009. The on-the-ground progress towards the EU goals has been slow due to several factors, including reluctant Member States, the political clout of the national champions, the market structure and long distances, and failures in regulation.<sup>96</sup>

However, the EU efforts to limit the role of take-or-pay contracts and liberation of parts of the network capacity paved the way for the events of 2010, when competition in the EU natural gas markets

<sup>95</sup> The data on energy is drawn from Bank of Finland, Policy Brief 4/2014, p. 6, available at: [http://www.suomenpankki.fi/bofit/tutkimus/tutkimusjulkaisut/policy\\_brief/Pages/bpb0414.aspx](http://www.suomenpankki.fi/bofit/tutkimus/tutkimusjulkaisut/policy_brief/Pages/bpb0414.aspx); the data on imports and exports is from Eurostat, STAT/14/13, 24 January 2014, available at: [www.europa.eu/rapid/press-release\\_STAT-14-13\\_en.pdf](http://www.europa.eu/rapid/press-release_STAT-14-13_en.pdf).

<sup>96</sup> For more details and analysis, see Talus, *supra* note 63.



finally took forward steps. This development materialized as high oil prices and the shale gas boom in North America coincided, with the former pushing long-term gas prices up and the latter leaving an LNG surplus on the world market and bringing relatively cheap LNG to European ports.<sup>97</sup> Since then, spot-priced gas has continuously increased its share particularly in Western Europe,<sup>98</sup> but crucially, eastern parts of the Union are notably lagging behind in the competition (see Figure 2). It is worth noting that for several EU Member States the ideological shift has been hard – and the geoeconomic motivation of national energy champions and governments to “defend turf” against competition from other Member States has been at play. The interaction between the state and national energy champions is still intimate and takes many forms within the EU countries. It was only in July 2015 that 15 EU and Energy Community countries in the Central Eastern Europe and South East European regions reached a general agreement to work together to accelerate the building of missing gas infrastructure links and to tackle the remaining technical and regulatory issues which hamper the development of an integrated energy market in the region.<sup>99</sup>

#### 4. Geoeconomics in action: the South Stream Pipeline Project

The SSPP aimed at bringing about the capacity to ship 63 billion cubic meters of Gazprom’s gas annually across the Black Sea to the Balkans and finally to Austria and Italy (Figure 3). The project was announced in June 2007 and a Memorandum of Understanding signed by Gazprom and Italian Eni in November 2007.<sup>100</sup> In September 2012 a consortium was formed in which Gazprom owns 50 percent, Eni has 20 percent, and French EDF and German Wintershall each own 15 percent of the offshore section.<sup>101</sup> The pipeline ownership in each transit country would be divided between Gazprom and a national partner with an equal split. According to the plans, 30 percent of the financing would be paid by the shareholders and 70 percent would come from credit financing.<sup>102</sup>

---

<sup>97</sup> Vihma, A 2013. “The Shale Gas Boom: The global implications of the rise of unconventional fossil energy”, *FIIA Briefing Paper 122*.

<sup>98</sup> Stern, J. and Rogers, H. 2014. “The Dynamics of a Liberalised European Gas Market: Key determinants of hub prices, and roles and risks of major players”, *The Oxford Institute for Energy Studies*, Paper No. 94, available at: <http://www.oxfordenergy.org/wpcms/wp-content/uploads/2014/12/NG-94.pdf>.

<sup>99</sup> European Commission - Press release, Energy: Central Eastern and South Eastern European countries join forces to create an integrated gas market - 10 July 2015: [http://europa.eu/rapid/press-release\\_IP-15-5343\\_en.htm](http://europa.eu/rapid/press-release_IP-15-5343_en.htm).

<sup>100</sup> See Eni, [http://www.eni.com/en\\_RU/eni-russia/partners-projects/gazprom/gazprom.shtml](http://www.eni.com/en_RU/eni-russia/partners-projects/gazprom/gazprom.shtml),.

<sup>101</sup> Dizdarevic, *supra* note 1.

<sup>102</sup> “Final decision on South Stream pipeline in sight”, Euractiv, 17 July 2012.



Figure 3. Projected South Stream pipeline route options.<sup>103</sup>

From the outset, the mainstream perception of analysts has been that the project is motivated by geoeconomics – a strategic advantage rather than commercial viability. With no growth expected in the European gas market,<sup>104</sup> and Gazprom having to bear a large part of the building costs, estimated at \$40 billion,<sup>105</sup> or even €50 billion according to another estimate,<sup>106</sup> the business case for implementing the South Stream plan was “always weak”.<sup>107</sup> The EU’s demand for gas has declined owing to weak economic performance since 2008, cheap coal enabled by America’s shale gas boom since 2010, and the expansion of renewable energies, especially since 2010. As summarized by a prominent analyst, “South Stream is a very expensive landline to markets that may not be all that lucrative”.<sup>108</sup>

As the weak projected commercial profitability suggests, the motivation for South Stream was instead based on geoeconomic advantages and enhancement of Russia’s sphere of influence. Firstly, Russia could increase its leverage over Ukraine, depriving the country of gas transit revenue and its key lever in Moscow as a transit state between Russia and the EU markets.<sup>109</sup> With the SSPP, Gazprom would acquire an alternative route to many customers in Europe which can currently only be accessed via Ukraine. This would leave Ukraine exposed to price increases and cut-offs, as Gazprom could switch off supplies without

<sup>103</sup> See Gazprom, [www.gazprom.com](http://www.gazprom.com), retrieved 6 March 2015. Note that the map does not recognize Kosovo and marks Crimea as part of the Russian Federation.

<sup>104</sup> Honore, A. 2014. The Outlook of Natural Gas Demand in Europe. Oxford Institute for Energy Studies.

<sup>105</sup> Stern, J., Pirani, S. & Yafimava, K. “Does the cancellation of South Stream signal a fundamental reorientation of Russian gas export policy?”, *The Oxford Institute for Energy Studies*, Comment, January 2015: <http://www.oxfordenergy.org/wpcms/wp-content/uploads/2015/01/Does-cancellation-of-South-Stream-signal-a-fundamental-reorientation-of-Russian-gas-export-policy-GPC-5.pdf>.

<sup>106</sup> Maltby, T. 2013. “Europe’s south-eastern pipedreams: South Stream as an energy security provider?”, *European Centre for Energy & Resource Security*, EUCER Newsletter 22.

<sup>107</sup> “Demise of South Stream big setback for Putin”, *Financial Times*, 2 December 2014.

<sup>108</sup> “A Conduit for Russian Gas, Tangled in Europe’s Conflicts”, *The New York Times*, 30 June 2014.

<sup>109</sup> Dizdarevic, *supra* note 1, p. 3.

inconveniencing other European clients.<sup>110</sup> Russia has strongly championed SSPP since the Ukraine-Russia gas crisis in 2006 and 2009, as circumventing Ukraine and gaining the upper hand in the troublesome transit relations had gained political weight, and the attempts to negotiate partial or full ownership of the Ukrainian gas pipe network had failed. Several analysts see South Stream in this context as a “Plan B” for Russia, as the initiatives to form a consortium to manage the Ukrainian network had not produced similar results as with Belarus, in which Gazprom eventually was able to acquire 100 percent of Beltransgaz’s shares in 2011.<sup>111</sup>

Secondly, Russia stood to re-increase its influence in South-Eastern Europe, weakening the region’s alliance with the EU. This would take place by increasing the market share and the countries’ dependency on the Gazprom pipeline gas as a consequence. With SSPP, or so the geoeconomic reasoning goes, Russia could solidify its political influence within the countries on the projected route, especially among the small economies that have troublesome relations with the wider EU, such as Hungary and Greece, as well as the centuries-old ally, Serbia.<sup>112</sup> To a lesser extent, further influence could be exerted on big-market final destinations Italy and Austria, politically sympathetic energy-importers which have adopted less inflammatory language among EU countries on Russia’s geopolitical campaign in Ukraine.<sup>113</sup>

Thirdly, the project has effectively prevented competing plans to transport gas from Azerbaijan through Turkey into the EU market.<sup>114</sup> Another large gas supplier would increase competition in South-Eastern Europe – a long-lasting strategic priority of Brussels<sup>115</sup> – and the primary candidate has been the Shah Deniz gas field in the waters of Azerbaijan, potentially coupled with production from the Middle East.<sup>116</sup> Several such pipeline project plans have been competing with one another under the blueprint of the EU-backed “Southern Gas Corridor”.<sup>117</sup> Indeed, the plan to build SSPP originally surfaced in 2007 when the EU, alarmed by the first Ukrainian gas crisis, was launching negotiations for a competing pipeline.<sup>118</sup>

A particular political and legal struggle in the geoeconomics between the EU and Russia was not only whether to build the SSPP, but on whose terms the pipeline would function. This question became politicized in the context of the bilateral agreements negotiated and signed by Russia and European partner

---

<sup>110</sup> “South Stream gas project may now be a pipe dream”, *Financial Times*, 24 August 2014.

<sup>111</sup> “Gazprom’s Offer to Belarus: Modernisation à la Russe?”, *Natural Gas Europe*, 5 December 2012

<sup>112</sup> Liuhto, *supra* note 6, pp. 26-28.

<sup>113</sup> On the backdrop to Austria-Russia relations, see Astrov, V. “Austria: Relations with Russia and Implications for the EU Eastern Partnership”, in: Foti G. and Ludvig Z. (eds), *EU-Russian relations and the Eastern Partnership: Central-East European member state interests and positions* (Budapest: Hungarian Academy of Sciences, 2009 ), pp. 165-182. On the current Italy-Russia relations, see Tocci, N. 2014. “How Should Europe Respond to Russia? The Italian view”, *European Council on Foreign Relations*, Commentary, 18 November 2014.

<sup>114</sup> This strategic viewpoint has been emphasized by many analysts; see for example Chow, E. 2015. “Russian Gas Stream or Dream”, *Center for Strategic & International Studies*, 12 February 2015.

<sup>115</sup> “Southern Gas Corridor: Vice-President Šefčovič attended Ministerial Meeting in Baku”, DG Energy, European Commission, see, <http://ec.europa.eu/energy/en/news/southern-gas-corridor-vice-president-%C5%A1ef%C4%8Dovi%C4%8D-attended-ministerial-meeting-baku>.

<sup>116</sup> For a summary, see <http://www.eurodialogue.eu/energy-security/Europe-southern-gas-corridor-The-great-pipeline-race>.

<sup>117</sup> For more details, see Trans-Adriatic Pipeline pages, <http://www.tap-ag.com/the-pipeline/the-big-picture/southern-gas-corridor>.

<sup>118</sup> See <http://www.eurodialogue.eu/energy-security/Europe-southern-gas-corridor-The-great-pipeline-race>.

countries on the projected pipeline route between 2008 and 2011. These intergovernmental agreements were made with EU Member States Austria, Bulgaria, Croatia, Greece, Hungary and Slovenia, as well as Serbia, which is currently negotiating for its accession to the EU.<sup>119</sup> A Memorandum of Understanding was also signed with *Republika Srpska*, the ethnically Serb part of Bosnia.<sup>120</sup> Similarly, Gazprom signed bilateral agreements on cooperation with the authorized national partners and set up joint project companies in each transit country, usually owned to 50 percent by both parties.<sup>121</sup> The signing of the agreements was typically complemented with a new gas contract, such as the one which Bulgarian PM Boyko Borisov and Gazprom CEO Alexei Miller announced simultaneously with their SSPP bilateral agreement in 2012, giving Bulgaria a 20 percent price cut for the next 10 years.<sup>122</sup> In 2013 Gazprom hosted official welding ceremonies in Bulgaria and Serbia,<sup>123</sup> as well as a signing ceremony in Hungary.<sup>124</sup> These events were interpreted as geoeconomic showcases for Russia's seriousness regarding the project – the timing of the events suggests that a geoeconomic motivation to impress Ukraine to opt for Russia's Customs Union was likely present.<sup>125</sup> For the EU Commission, the project was still in a rather early planning phase, as Gazprom has not officially presented the precise route of the pipeline.<sup>126</sup>

In short, the SSPP agreements represent the traditional energy order and would require notable exemptions, as they contain provisions that breach the relevant energy and competition legislation of the EU.<sup>127</sup> The former includes the rules aimed at creating the EU-wide internal market in natural gas, and the latter includes the competition rules that aim to prevent the abuse of a dominant position, and enforce antitrust proceedings. Under the current EU legislation, gas transport system operators must build gas interconnectors in accordance with the regulated third-party access principle.<sup>128</sup> National authorities may request exemptions from the third-party access rules. The national regulatory authority must assess the request for exemption submitted by an operator, and the national regulator's decision then needs Commission approval. The Commission's opinion is binding. For infrastructure projects that affect several EU countries, the Agency for the Cooperation of Energy Regulators (ACER) may coordinate the different requests. The Commission and ACER only exceptionally grant exemptions from third-party access or the implementation of provisions on unbundling. Officially, these exemptions are granted on the basis of criteria,

---

<sup>119</sup> Dizdarevic, *supra* note 1.

<sup>120</sup> *Ibid.*

<sup>121</sup> *Ibid.*

<sup>122</sup> "Gazprom Secures South Stream Deal", *Financial Times*, 15 November 2012.

<sup>123</sup> "South Stream construction starts in Bulgaria", Gazprom Press Release, 31 October 2013; "South Stream comes to Serbia", Gazprom Press Release, 24 November 2013.

<sup>124</sup> "Contract signed for South Stream design in Hungary", Gazprom Press Release, 12 December 2013.

<sup>125</sup> This has been suggested, for example, by Dizdarevic, *supra* note 1, p. 6.

<sup>126</sup> Comments by Commissioner Gunther Oettinger, for example in EGF Gazprom Monitor, Issue 19, December 2012, p. 2.

<sup>127</sup> The relevant EU legislation consists of Directives and Regulations from the Third Package, consisting of Directive 2009/72/EC, Directive 2009/73/EC, Regulation (EC) No 713/2009, Regulation (EC) No 714/2009, and Regulation (EC) No 715/2009, as well as the rules on protection of competition from the TFEU - Treaty on the Functioning of the European Union, Official Journal C 326, 26 October 2012.

<sup>128</sup> Regulation (EC) No 715/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the natural gas transmission networks and repealing Regulation (EC) No 1775/2005.

which emphasize, for example, that the investment “must improve security of supply and boost competition in the gas market”.<sup>129</sup> However, in practice, the decision to grant exemptions is notably political. As noted by an analyst, under the conditions of the Ukraine crisis and the ensuing economic sanctions and counter-sanctions, the Commission was “in no mood to grant Gazprom further exemptions”.<sup>130</sup> Complying with EU legislation would add costs for the builder, for example by adding extra capacity to the pipeline.<sup>131</sup> More importantly, in geoeconomic terms, the application of relevant EU legislation would have markedly hindered Russia’s ability to use SSPP as a political tool, and was thus unacceptable for the Kremlin.

The EU Commission took action on the bilateral agreements on the SSPP as it was moving forward, and the matter was becoming increasingly political. In September 2012, the Commission announced investigations into the agreements, and shortly afterwards started to officially facilitate coordination among relevant Member States to investigate in detail how their bilateral agreements complied with EU energy market rules, competition law, public procurement rules, and environmental regulation. In December 2013, an account was duly published on the breaches of EU legislation found in the agreements.<sup>132</sup> As expected, the agreements raised concerns over the central issues of the internal energy market rules concerning ownership unbundling and blocking the access of third parties. The Commission also identified a tax regime that was most favorable to Gazprom and its partners (against the EU’s state aid rules), countries’ subcontracting and giving preferential treatment to their companies (against the EU’s rules on protection of competition), and companies establishing tariffs for pipeline usage by themselves (against the EU’s internal energy market rules).<sup>133</sup> From a political perspective, the major issues concerned unbundling, third-party access and tariff structure,<sup>134</sup> as these have direct consequences for the geoeconomic power in the natural gas trade.

Early in 2014, Gazprom “was on the brink of winning exemption” to the competition rules to supply extra gas to Germany, and this was interpreted by some as a sign that the Commission could also be flexible on the SSPP.<sup>135</sup> However, the Commission hardened its stance from concerns into outright opposition in late March and suspended the negotiations on exemptions, as the Ukraine crisis had evolved into warfare with mounting evidence of Russian military involvement. The Commission stated that “decisions on exemptions [for South Stream] from the third energy package are on ice for political reasons”.<sup>136</sup> In the meantime, the European Parliament took the view in an informal resolution that “the South Stream pipeline should not be built, and that other sources of supply should be made available”.<sup>137</sup>

---

<sup>129</sup> “Access to infrastructure and exemptions”, DG Energy, European Commission, see <https://ec.europa.eu/energy/en/topics/markets-and-consumers/wholesale-market/access-infrastructure-and-exemptions>.

<sup>130</sup> “South Stream project may now be a pipe dream”, *Financial Times*, 24 August 2014.

<sup>131</sup> Dizdarevic, *supra* note 1, p. 13.

<sup>132</sup> “South Stream bilateral deals breach EU law, Commission says”, EurActiv, 4 December 2013.

<sup>133</sup> Dizdarevic, *supra* note 1, p. 8.

<sup>134</sup> Highlighted, for example, by De Micco, P. 2013. “Delays to South Stream benefit Ukraine”, Quick Policy Insight, Directorate-General for External Policies, European Parliament, p. 2.

<sup>135</sup> “Russia’s South Stream gas pipeline to Europe divides EU”, *Financial Times*, 4 May 2014.

<sup>136</sup> *Ibid.*

<sup>137</sup> This non-binding resolution of the European Parliament “takes the view that the South Stream pipeline should not be built, and that other sources of supply should be made available”, EP 2014/2699(RSP), paragraph 28.

However, a rather common perception even after the onset of the Ukraine crisis was that a political and legal compromise would be reached, and that the SSPP could eventually move forward. Despite legal and political uncertainty, it was anticipated that the SSPP's momentum would be hard to reverse, especially according to industry analysts and company executives.<sup>138</sup> Most importantly, the Russian leadership calculated that Commission and Parliament actions in March could not "stop a moving train", and pushed for the construction with increased political and economic efforts.

After the political setbacks and hearing the possibility of legal proceedings in Brussels in March, Russia reacted to the hardened EU stance by redoubling its own geoeconomic efforts. With the depth of Europe's commercial ties to Russia and the conflicted loyalties of Member States, Gazprom signed a preliminary deal with the energy company OMV in May to extend the SSPP into Austria.<sup>139</sup> At the same time, Gazprom also announced deals with Switzerland's Allseas Group, and Italy's Saipem to build SSPP's underwater pipelines in the Black Sea.<sup>140</sup> President Putin visited Austria in June to gain support for the project.<sup>141</sup>

During her visit to Moscow in July, Italian foreign minister Federica Mogherini and Russian foreign minister Sergei Lavrov stated in a press conference that Italy and Russia "confirm our goal on completing the construction project of the South Stream gas pipeline ... and to continue active work in order to remove all issues that may arise, including in regard to the dialogue with the European Commission".<sup>142</sup> Evidence of Hungarian loyalty to the Kremlin was seen in September 2014 when Hungary cut off the reverse gas flows from the EU to Ukraine, only days after Gazprom CEO Miller had visited the country.<sup>143</sup> President Putin also travelled to Italy and Serbia in October to support then EU President Italy's and Serbia's stance on the SSPP, stressing the continuation of business relations in spite of the Ukraine crisis and "reducing transit gas risk" with South Stream.<sup>144</sup> Hungary confirmed its unconditional support for the SSPP in November, passing an amendment to the procurement rules for pipelines, designed to forestall legal objections from Brussels to the construction of the SSPP.<sup>145</sup>

In June, the EU Commission launched a legal investigation in Bulgaria,<sup>146</sup> and stated in its annual enlargement report that Serbia's accession process would suffer if the project moved forward before the agreement with Russia was aligned with the EU's *acquis communautaire*.<sup>147</sup> In September, the European

---

<sup>138</sup> See for example, "A Conduit for Russian Gas, Tangled in Europe's Conflicts", *The New York Times*, 1 July 2014.

<sup>139</sup> "South Stream project may now be a pipe dream", *Financial Times*, 24 August 2014.

<sup>140</sup> *Ibid.*

<sup>141</sup> "Austria defies US, EU over South Stream during Putin visit", *Deutsche Welle*, 25 June 2014.

<sup>142</sup> "Italian EU presidency backs South Stream", *EU Observer*, 10 July 2014.

<sup>143</sup> "Hungary suspends gas supplies to Ukraine under pressure from Moscow", *The Guardian*, 26 September 2014.

<sup>144</sup> "Putin Pushes South Stream in Belgrade, Milan", *New Europe*, 14 October 2014.

<sup>145</sup> "Hungary paves way for Gazprom pipeline", *Financial Times*, 5 November 2014.

<sup>146</sup> "EU Commission Reiterates Calls on Bulgaria to Stop South Stream", *Sofia News Agency*, 3 June 2014.

<sup>147</sup> "EU puts pressure on Serbia to stop South Stream gas pipeline", *EU Observer*, 7 October 2014.



Parliament passed a resolution calling on Member States to cancel the planned energy sector agreements with Russia, including the SSPP.<sup>148</sup>

The status of the project was confusing, not only legally and politically, but at the ground level of the construction work as well. Here, Bulgaria emerged as the main field of SSPP geoeconomics. The other possible transit country, Romania, has its own gas reserves and is considered a lost-cause politically by Russia, whereas the next countries on the transit route, Serbia and Hungary, could always be counted on to support the project.<sup>149</sup> SSPP construction and the alleged corruption involved in the Bulgarian contracts were among the main election themes in the country in the summer of 2014. According to press reports, there was “a secret meeting between Bulgarian Prime Minister and the head of Gazprom”, after which the pipeline contracts were given to “a company controlled by a member of Mr. Putin’s inner circle [Gennady Timchenko] and politically connected Bulgarian companies”.<sup>150</sup> According to the European Council on Foreign Relations, the projected price of SSPP in Bulgaria, €7 million per kilometer, was more than twice what a similar pipeline construction would cost in Germany.<sup>151</sup> The difference between the prices was interpreted as a “sophisticated type of corruption” that would, through subcontractors, hugely benefit different political actors in Bulgaria – and that “same mechanism would work in Serbia as well”.<sup>152</sup> As late as August 2014, Gazprom shipped pipes to Varna harbor in Bulgaria and worked on the construction,<sup>153</sup> in spite of Bulgarian PM Plamen Oresharski promptly denying that there was ongoing construction work,<sup>154</sup> and the forthcoming PM Boyko Borisov underscoring the need for EU approval before launching any work on the pipeline.<sup>155</sup> In September, Gazprom announced that construction work on the Serbian stretch would start soon.<sup>156</sup> The new coalition government elected in Bulgaria in October was regarded as leaning more towards Brussels than the preceding Socialist government, and Borisov again officially emphasized that an agreement between Brussels and the Kremlin would be needed before construction could proceed.<sup>157</sup>

On 1 December 2014, in a surprise turn of events to many, President Putin announced that Russia would abandon the project.<sup>158</sup> Among the surprised were the closest European partners such as Saipem, the contracting subsidiary of Italian energy company ENI, noting that it had not received any formal notification

---

<sup>148</sup> “MEPs welcome signs of hope in Ukraine and urge the EU to stand up to Russia”, Press Release, European Parliament, 18 September 2014.

<sup>149</sup> As late as November 2014, the Foreign Ministers of Serbia and Hungary stated “we are confident that it (South Stream) will significantly boost the security of gas supplies for Central Europe”, see [http://www.b92.net/eng/news/business.php?yyyy=2014&mm=11&dd=21&nav\\_id=92334](http://www.b92.net/eng/news/business.php?yyyy=2014&mm=11&dd=21&nav_id=92334).

<sup>150</sup> “How Putin Forged a Pipeline Deal That Derailed”, *The New York Times*, 30 December 2014.

<sup>151</sup> “Bulgaria’s new coalition and the future of South Stream”, European Council on Foreign Relations, 11 November 2014.

<sup>152</sup> *Ibid.*

<sup>153</sup> “Bulgaria says it has ‘frozen’ South Stream, but pipes continue to arrive”, EurActiv, 21 August 2014. For video footage of the pipes arriving at Varna harbor, see [https://www.youtube.com/watch?v=1z\\_UToB6F9g](https://www.youtube.com/watch?v=1z_UToB6F9g).

<sup>154</sup> “Bulgaria deals Russia setback over gas pipeline project”, *Financial Times*, 9 June 2014.

<sup>155</sup> “Bulgaria’s likely next PM says will build South Stream only if EU happy”, Reuters, 18 June 2014.

<sup>156</sup> “Gazprom: Serbia will start building South Stream in October”, EurActiv, 17 September 2014.

<sup>157</sup> “Bulgaria’s likely next PM says will build South Stream only if EU happy”, Reuters, 18 June 2014.

<sup>158</sup> “In Diplomatic Defeat, Putin Diverts Pipeline to Turkey”, *New York Times*, 1 December 2014.



that the project had been scrapped.<sup>159</sup> Most contractors and partners did not respond to requests for comment,<sup>160</sup> indicating confusion after an apparently sudden and unilateral decision by President Putin. In his remarks, President Putin framed the demise of SSPP as a loss to Europe and named the then Commission as the main culprit, “depriving Bulgaria of the possibility of behaving like a sovereign state”.<sup>161</sup> Gazprom’s stock rose slightly after the news broke, indicating that the profitability concerns were widely shared among its investors.<sup>162</sup> SSPP’s geoeconomic motivation was thus verified by the marketplace. The stocks of European contractors expected to be involved in the construction dropped sharply,<sup>163</sup> highlighting that the decision to abandon South Stream indeed came as a surprise to analysts, and had not been anticipated by the markets.

In January 2015, Gazprom notified the EU Commission’s Vice-President that within a few years, Gazprom would stop delivering to the EU via Ukraine, and would only make an amount of gas available at the Greek-Turkish border. CEO Miller was quoted as saying that as “South Stream is dead”, there will be “no other gas transit options than the new Turkish Stream pipeline”.<sup>164</sup> According to Miller, it is up to the European partners to “put in place the necessary infrastructure”.<sup>165</sup> However, it is difficult to estimate whether Miller’s words were aimed at impressing domestic audiences, or at actually launching new negotiations with foreign partners. The announcement of the \$12 billion Turkish Stream reinforced Russia’s reputation as an unreliable trading partner.<sup>166</sup>

For now, the Turkish Stream project is not much more than a blueprint. Both parties have signed a Memorandum of Understanding, and will perhaps negotiate the prices and quantities in due course.<sup>167</sup> Market analysts have expressed doubt about the prospects of gas exports to the EU via Turkey, which would require substantial investment in new infrastructure in South-eastern Europe by many of the same countries that are still smarting over the demise of the SSPP.<sup>168</sup> Turkey’s own gas market is growing, but not nearly fast enough to accommodate gas imports on a scale comparable to those the SSPP was intended to mobilize.<sup>169</sup> However, as the SSPP case has revealed, large-scale pipeline projects are turbulent and prone to political uncertainty: Even while the actual pipes are being transported around the region, the project may be called off. The downing of a Russian Su-24 warplane by the Turkish armed forces illustratively captures the geopolitical antagonism between Turkey and Russia in Syria,<sup>170</sup> which has caused

---

<sup>159</sup> “Few Contractors Vocal on South Stream Status”, United Press International, 3 December 2014.

<sup>160</sup> *Ibid.*

<sup>161</sup> “Putin blames EU as Russia abandons plans for South Stream gas pipeline”, *The Guardian*, 1 December 2014.

<sup>162</sup> See Gazprom, <http://www.gazprom.com/investors/stock/stocks>.

<sup>163</sup> “Putin loses face with cancellation of ‘pharaonic’ South Stream”, *Financial Times*, 2 December 2014.

<sup>164</sup> “Russia says it will shift gas transit from Ukraine to Turkey”, EurActiv, 15 January 2015.

<sup>165</sup> “Russia to Shift Ukraine Gas Transit to Turkey as EU Cries Foul”, Bloomberg, 14 January 2015.

<sup>166</sup> Gregory P., “Putin’s Gas Problem”, Project Syndicate, 26 Feb 2015, see <http://www.project-syndicate.org/commentary/russia-ukraine-gas-pipeline-by-paul-r--gregory-2015-02#YJZP0vzfOeFMCa3v.99>.

<sup>167</sup> “In Search of New Partners: Putin’s Turkish Stream for Turkey”, Natural Gas Europe, 11 February 2015.

<sup>168</sup> Chow, E. 2015. “Russian Gas Stream or Dream”, *Center for Strategic & International Studies Commentary*, February 2015, available at: <http://csis.org/publication/russian-gas-stream-or-dream>.

<sup>169</sup> *Ibid.*

<sup>170</sup> “No Room for Manoeuvre”, *The Economist*, 28 November 2015.

Russia to at least temporarily freeze the Turkish Stream project.<sup>171</sup> The geopolitics in Syria may also have broader consequences in the energy relations of the two aspiring regional powers.

Meanwhile, in 2014, as the battle over SSPP intensified, Russia finally began to make progress in its efforts to diversify its markets for natural gas. It signed two agreements with China to supply 30bn cubic meters of pipeline gas annually – once the projected Power of Siberia pipelines connecting Krasnoyarsk, Irkutsk and Yakutia production centers to the Chinese border has been built, optimistically within four to five years.<sup>172</sup> While this long-term project is a breakthrough in Russian-Chinese energy trade and investment, the envisaged supply of 38bn cubic meters of gas (in 2018) to China is only a fourth of the volume of gas Russia exported to Europe in 2013 alone,<sup>173</sup> and the gas supplies destined for China will not exploit the same energy deposits used for Europe. Secondly, the current economic environment in Russia, with its unprecedented economic downturn since the 1990s, low oil prices, serious weakening of its currency,<sup>174</sup> and problems of access to capital due to economic sanctions,<sup>175</sup> poses difficulties for several future large-scale investments. According to the 2014 audit report of Gazprom, Russia sold 15 percent less gas in 2014 than in 2013, which means a loss of \$2.2 billion from the European market.<sup>176</sup>

## 5. Conclusions

Was the SSPP merely another EU-Russia trade dispute, comparable to railway tariff disputes with the Baltic States or the timber tax dispute with Finland? The analysis and process tracing presented here disagrees with that notion, emphasizing that the SSPP was a strategic priority for Russia that became a victim of the Russian leadership's Ukraine adventurism, or even "one of the biggest casualties of the East-West stand-off over Ukraine".<sup>177</sup> Furthermore, the geoeconomic perspective underscores that the SSPP case is more than a trivial tug of war over a pipeline project. As indicated by the process tracing exercise, Russian leadership estimated in the spring of 2014 that it could advance two European strategies simultaneously: a geoeconomic one (constructing SSPP) and a geopolitical one (the military campaign in Ukraine). Here, Putin, frequently

<sup>171</sup> "Russia May Freeze Turkish Stream Gas Project - Gazprom Sources", 1 December 2015.

<sup>172</sup> See Gazprom, <http://www.gazprom.com/about/production/projects/pipelines/ykv>.

<sup>173</sup> Granholm *et al.*, *A Rude Awakening – Ramification of Russian Aggression towards Ukraine* (Eds.), (FOI, June 2014 – ISSN 1650-1942) p. 75.

<sup>174</sup> Following the sanctions imposed on Russia and nearly 40% fall in petrol prices since July 2014, the Russian currency, ruble, fell to a new low against the US dollar and the euro. For overview of the fall of ruble against the USD, see: <http://www.xe.com/currencycharts/?from=RUB&to=USD>. Galouchko K., Ruble slides most in emerging markets on sanctions, 13 November 2014, Bloomberg, <http://www.bloomberg.com/news/2014-11-13/ruble-slides-most-in-emerging-markets-on-sanctions-brent.html> and Hille K. *et al.*, Ruble suffers worst fall since 1998 crisis, Financial Times, 04 December 2014, <http://www.ft.com/cms/s/0/4bb50fcc-7937-11e4-9567-00144feabdc0.html?siteedition=uk#axzz3Mdc79a5j>.

<sup>175</sup> Council Regulation (EU) No 833/2014 of 31 July 2014 concerning restrictive measures in view of Russia's actions destabilising the situation in Ukraine. Also see, Commission Guidance note on the implementation of certain provisions of Regulation (EU) No 833/2014. For the US sanctions (in the form of Executive Orders) on Russia, see the US Department of State, <http://www.state.gov/e/eb/tfs/spi/ukrainerrussia/>.

<sup>176</sup> Gregory P., Russia's Natural Gas Sales Plummet: Is Russia Captive To European Buyers?, Forbes, 24 Dec 2014, <http://www.forbes.com/sites/paulroderickgregory/2014/12/24/russias-natural-gas-sales-plummet-is-russia-captive-to-european-buyers/>.

<sup>177</sup> "South Stream gas project may now be a pipe dream", *Financial Times*, 24 August 2014.

described by political commentators as a master strategist,<sup>178</sup> overplayed his hand. The EU is still searching for a common overall policy to confront Russian aggression in Ukraine, but in the pipeline politics Putin seems to have succeeded in increasing unity, to a certain degree, among the objects of his policy. From March 2014 onwards, the EU was able to harden its line on SSPP. The global energy context, including cheap coal prices, expansion of renewable energies, more liquefied natural gas and spot trading, cannot fully account for the assertiveness of the EU Commission and the allegiance of Member States in the SSPP case.

On a more general level, the SSPP case study highlights the incompatibility of geoeconomic and traditional geopolitical strategies. Europe's dependence on Russia for gas has been widely viewed as limiting the scope of the EU's response to Russia's military aggression in Ukraine.<sup>179</sup> The other perspective, the harm to Russian geoeconomic power caused by the geopolitics in Ukraine, has not been adequately addressed or analyzed. Russian geoeconomic activity has long been successful as a *centrifugal*, dividing power within the EU. The geopolitical campaign in Ukraine, in stark contrast, has been a *centripetal* force, causing enhanced EU unity, eventually seen for example in the SSPP case. Similar centripetal tendencies caused by a perceived geopolitical threat can be witnessed in the emerging German leadership in EU foreign policy,<sup>180</sup> the economic sanctions imposed against Russia,<sup>181</sup> and the re-emerging wider discussion on an energy union.<sup>182</sup> Although contemporary analysts are keen to evoke Von Clausewitz,<sup>183</sup> it seems that claims of geoeconomics being a continuation of war by other means are analytically poor and potentially misleading. The means of geopolitical power projection and tools of geoeconomic power have notably different effects in the contemporary, interconnected world.

As Makarychev asserted, "Russia and the EU build their policies on drastically dissimilar concepts of power and divergent conceptualizations of the state and its functions".<sup>184</sup> If geopolitics and geoeconomics are competing strategies (for Russia), so are geoeconomics and economic liberalism (for the EU). The heritage of the 1990s, promoting liberal order and interdependency to enhance regional security, may hinder the EU's ability to play geoeconomic games with strategically-oriented, state-capitalist Russia. For a considerable time, Brussels, operating through the emulation of the *acquis communautaire*, has pressed Gazprom and its partners to comply with EU rules on energy markets and competition. Among the main

---

<sup>178</sup> See for example, Bassett L. "Mike Rogers: Putin is playing chess, Obama is playing with marbles", *Huffington Post*, 2 March 2014.

<sup>179</sup> "A Conduit for Russian Gas, Tangled in Europe's Conflicts", *The New York Times*, 30 June 2014.

<sup>180</sup> E.g. Speck U. "German Power and the Ukraine Conflict", *Carnegie Europe*, March 2015; Meister S. "Reframing Germany's Russia Policy – An opportunity for the EU", Policy Brief, *European Council on Foreign Relations*, April 2014; Pond E. 2015 "Germany's Real Role in the Ukraine Crisis", *Foreign Affairs* Vol. 94, No. 2, pp. 173-176.; Trenin D. "The end of consensus: what does Europe want from Russia?", *Eurasia Outlook*, Carnegie Moscow Center, December 2014.

<sup>181</sup> Dolidze, T. 2015. "EU Sanctions Policy towards Russia: The Sanctioner-Sanctionee's Game of Thrones", CEPS Working Document, available at: <http://www.ceps.eu/system/files/WD%20402%20TD%20Sanctions.pdf> [accessed 5 July 2015].

<sup>182</sup> For an excellent discussion, see Van Renssen S. "Jean-Michel Glachant: Dreaming of the EU Energy Union" *Energy Post*, 24 February 2015, available at: <http://www.energypost.eu/interview-jean-michel-glachant-get-energy-union-need-new-institutions/>.

<sup>183</sup> See for example, "Financial War: Subject to sanction", Bloomberg, 17 December 2014.

<sup>184</sup> Makarychev A., 2014. Russia, Ukraine and the Eastern Partnership: From Common Neighborhood to Spheres of Influence?, *Insight Turkey*, Vol. 16, No.3, pp. 181-199.

concerns has been third-party access to pipelines, the unbundling of network ownership and gas supply, and the tariff structure for pipeline use. The political essence of these rules is that the EU Commission is trying to limit Russian geoeconomic power by creating a resilient single market – or more realistically a variant of “regulated competition”,<sup>185</sup> the second-best outcome after a liberal market-based order. Russia, on the other hand, has launched a dispute over the EU’s third energy package at the World Trade Organization.<sup>186</sup> This is rather an unusual but a positive move for Russia as the WTO dispute settlement mechanism provides an independent, rule based system of adjudication which Russia has continuously avoided in the past.

In spite of the recent centripetal tendencies, Member States have naturally supported different political responses to Russian geoeconomic activity in the energy sector. Different understandings of or disregard for EU solidarity as well as unilateral actions to deal with Russian geoeconomics will test the Union’s internal cohesion in the future. It is crucial to note that the national positions within the EU are not straightforward derivatives of energy trade with Russia. For example, Russian gas makes up a larger share in the primary energy consumption of Finland than that of Poland.<sup>187</sup> Therefore, one can argue that Poland’s frequent and vocal criticism toward Russian energy geoeconomics – notably the Nord Stream and South Stream pipelines – is not about energy security as such, but rather about conventional security policy. Poland assumes, to a certain extent, that the less sovereign Ukraine becomes, the more security concerns Poland will face from the East.<sup>188</sup>

The years of struggle for the SSPP will leave a scar on EU-Russia energy relations. The geoeconomic wrangling over the rules of the natural gas trade in Europe continues in negotiations between Brussels and the Kremlin, in national election campaigns in several EU member states, in corporate boardrooms, and in civil litigation across Europe. Although the ultimate outcome hangs in the balance, the idea of Russian energy invincibility, in which “energy politics may ultimately define the shape of relations between Russia and the West during this latest crisis in Ukraine”,<sup>189</sup> has been compromised by the demise of the SSPP.

---

<sup>185</sup> Talus, *supra* note 63, p. 1025.

<sup>186</sup> European Union and its Member States — Certain Measures Relating to the Energy Sector, DS476, [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds476\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds476_e.htm).

<sup>187</sup> See, Figure 1, p. 9.

<sup>188</sup> Similarly, see Liuhto, *supra* note 6, p. 12.

<sup>189</sup> The Russian supremacy in energy has been highlighted, for example, by scholars from Harvard University, noting in the summer of 2014 that “*Fears of a cold European winter without adequate amounts of natural gas from Russia are outweighing U.S.-led pressure for tougher sanctions against Moscow.*” See, [http://belfercenter.hks.harvard.edu/publication/24663/eu\\_must\\_resist\\_temptation\\_of\\_energy\\_union.html?breadcrumb=%2Fproject%2F68%2Fgeopolitics\\_of\\_energy\\_project](http://belfercenter.hks.harvard.edu/publication/24663/eu_must_resist_temptation_of_energy_union.html?breadcrumb=%2Fproject%2F68%2Fgeopolitics_of_energy_project).